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Japan-Brazil and German-Brazil Treaty Application to
Withholdings on Interest Paid
INTL-0482-89

This letter responds to your inquiry regarding interpretation of the Japan-Brazil and the German-Brazil Income Tax Treaties. Specifically, you have presented us with the following fact patterns: In the first situation, a U.S. branch of a Japanese bank loans money to a Brazilian borrower. In the second situation, a German branch of a U.S. bank loans money to a Brazilian borrower. Assuming each branch has a permanent establishment (in the U.S. and Germany, respectively) and the interest income received from the Brazilian borrower is attributable to the permanent establishment, you have asked whether the reduced treaty rates apply to the Brazilian withholding tax on interest for U.S. foreign tax credit purposes and for purposes of determining the correct gross-up amounts for net loans. Article 10(2) of the Japan-Brazil Treaty provides for a 12.5% withholding tax rate for Brazilian source interest paid to a resident of Japan. Paragraph 2(b) of Article 11 of the German-Brazil Treaty provides for a 15% withholding tax rate for Brazilian source interest paid to a resident of Germany.

As we have stated to you in a telephone conversation, we do not have the authority or expertise to interpret non-U.S. tax treaties. However, in order to be as helpful as possible, we have contacted an outside Brazilian attorney, Paulo Bekin, who we have used as an expert witness in recent tax litigation, for an informal opinion about the Brazilian law issues you have raised. A copy of his response is attached. In summary, it states that when a U.S. branch of a Japanese bank loans money to a Brazilian borrower, the treaty between Brazil and Japan is applicable. As the treaty is applicable to interest paid from Brazil to the branch of a Japanese bank in another country, the correct

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rate of Brazilian tax for both gross-up and credit purposes is 12.5%. This means that a foreign tax credit can be claimed in the amount of 12.5%. Any excess withheld is considered a non-compulsory payment under section 1.901-2(e)(5) of the Income Tax Regulations and will not be creditable. See, section 906 of the Internal Revenue Code.

The German branch of a U.S. bank that receives interest payments from a Brazilian borrower however is not entitled to the reduced withholding rate. This is because the treaty is not applicable to the interest paid from Brazil to branches located in Germany with head offices in third countries. Therefore, the correct rate of tax for both gross-up and credit purposes is 25%. A foreign tax credit will be allowed for the entire 25% withheld, as none is considered a non-compulsory payment under section 1.901-2(e)(5) of the regulations.

It should be noted that the conclusion here assumes that the Service does not prevail in its litigation denying full credit for the Brazilian tax because the lender is not legally liable for the tax.